The Mix of Adjustment and Financing Policies

5. Whether or not the non-oil LDCs will be able to sustain their growth rates in the 1980s will depend primarily on three factors: first, on the willingness and ability of these countries to adjust their policies to the new circumstances, given the widely-differing situations and natural growth potentialities of individual countries; secondly, on the policies adopted by the OECD countries; and thirdly, on the ability of the financial system to support suitable policies and programs by the provision of finance on the required scale and at acceptable terms. We will briefly consider each of these.

(a) Policies for developing countries

6. The ability of many developing countries to sustain growth in the 1970s, partly due to considerable improvements in their standards of economic management, provides some grounds for confidence in their ability to weather successfully the even harsher climate of the 1980s. Where the large current deficits which non-oil developing countries have run for many years found their counterpart in increased domestic investment, they are not a measure of distress; on the contrary, they are indicative of the success of these countries' economic policies. On the side of the supply of international capital, they reflect the greatly-expanded ability of the international banking system to permit, and even encourage, a much larger transfer of real resources than would have been possible even 15 years ago. It is banks' willingness to lend and the ability of many non-oil LDCs to use the funds productively, as much as OPEC's action in raising oil prices, which created the conditions in which imbalances on the present scale can arise and persist. Without such a mechanism, OPEC's attempt at raising oil prices would not have produced large payments surpluses, but would merely have pushed the world into a deep depression.

7. In present circumstances, several different concepts of "adjustment" may be distinguished. One concept refers to the adoption of policies to deal selectively with the particular problems caused by the further rise in the cost of imported oil—notably energy conservation and the development of alternative sources of energy. (Fortunately, several developing countries outside OPEC have since 1973 become net oil-exporters themselves and others have prospects of becoming largely or wholly self-sufficient). A second approach refers to the need for countries to adopt suitable macro as well as micro-policies to deal with the changes in their environment—notably the prospective slowdown in OECD growth rates and the change in relative prices—even if their policies had been quite

appropriate in the previous situation. A third concept relates to the need for countries to adjust policies—such as excessive government deficits or overvalued exchange rates—that would bring about payments difficulties in any circumstances. Traditionally, the International Monetary Fund has focused on the third category and such adjustment continues to be essential where basic policies are defective. In present conditions, however, the other concepts of adjustment are relevant over the entire spectrum of developing countries.

8. The adjustment programs to be chosen by different countries, and the mix between adjustment and financing, will vary widely. All countries are confronted with the need to effect structural changes in their economies in reaction to the steep increase in the real cost of energy; some may be able to effect these changes while maintaining rates of economic growth that are high by historical standards; others will have to apply longer-lasting restraints on demand, and to scale down their development plans; some will need to attend urgently to the correction of policies that would be inappropriate in any circumstances. It is neither possible nor desirable to prescribe general rules applicable in all circumstances. Purveyors of credit (aid-giving countries, commercial banks, the IMF and the World Bank) will need to realize, in their lending policies, the wide diversity of country situations and the consequent need for divergencies in adjustment policies.

9. It is clear that the oil-price shock puts a premium on high standards of economic management. In general, countries which give high priority to creating the conditions necessary to increase the total flow of savings (domestic and external) available to them will have the best chances over time of resuming previous growth rates. Given the remarkable flexibility demonstrated by several fast-growing LDCs in the 1970s, it is not out of the question that some countries will in this way, and in even more adverse circumstances, be able to accomplish adjustment through growth. Other countries will find it difficult or impossible to accomplish successful adjustment in this way, particularly where pressure to maintain previous rates of growth in real incomes is strong. Adjustment will often require far-reaching changes in the patterns of output and trade; action to improve the functioning of markets and the price mechanism; the reform of taxation policies and the management of public expenditure; the adoption of new energy policies; the removal of obstacles to efficient investment, whether foreign or domestic; and possibly a variety of other measures to hold down levels of consumption and mobilize savings.

(b) Policies for Industrial Countries

10. With regard to the major industrial countries, the emphasis of demand policies at present is placed on the need to maintain the struggle against inflation. The policy response to the second oil shock was shaped by the main lesson drawn from the first oil shock, namely that countries which acted in practice promptly to effect their adjustment also adjusted more successfully than others. There is still some dispute, however, as to whether this was indeed the right lesson—still less the only one—to be drawn from that experience. It would certainly not be correct to interpret this lesson as requiring the adoption of policies aimed at eliminating the payments deficits of the industrial countries. The main effect of the adoption of such policies would be to raise further the deficits of the non-oil LDCs. The effect on global payments current imbalances would be small. On the other hand, the need to avoid a cumulative round of belt-tightening should not become a pretext to avoid or postpone adjustment to the real loss of income brought about by the adverse movements in terms of trade. The posture of fiscal and monetary policies should be guided by the need to reduce inflation over the medium term.

11. An important fact in this connection is that the large industrial countries have generally found means of financing their payments deficits without major difficulties. In particular, Germany and Japan, which together accounted for a large fraction of the industrial countries' current account deficit for 1980, made arrangements for financing their payments deficits at least partly by means of capital inflows denominated in their own currencies. These transactions indeed provided oil-exporting countries with opportunities to diversify the currency composition of their foreign assets.

12. Although earlier fears of a deep world-wide recession have so far proved unfounded, it is still worth emphasizing that the present recession, if prolonged, will have increasingly severe effects on the LDCs; in particular, an additional share of the aggregate deficit is being shifted to the non-oil LDCs, so that they now bear a very large proportion of the total. As economic growth in the industrial countries in 1981 is likely to remain sluggish, possibly at only about 1 per cent, this process could still force the non-oil LDCs into such harsh measures of adjustment as to put back their development for a long time. In making their plans on how to deal with their economic difficulties, the large industrial countries should bear in mind such risks of the system, and be careful about the world-wide shock waves that sharp deflationary policies on their part might set off.

13. In an environment of sluggish growth and rising unemployment, several industrial countries are likely to come under increasing pressure from domestic sectional interests to adopt protectionist measures. In such a climate, it is particularly important that they should resolutely resist such pressures. Protectionist measures would bear very heavily on LDCs and would defeat the adjustment action that many of these countries have been taking, at great political and social cost to themselves. Such measures would indeed be particularly damaging precisely to those countries that have been trying to adopt outward-looking policies, and which are therefore most vulnerable to a further deterioration in the prospects for world trade. For an industrial country or group of countries to step back from the open trading principles that they have undertaken to follow, and enjoined on developing countries, would be regarded as an act of betrayal. By giving the wrong signals at the wrong time, it would also jeopardize the entire structure of the world's open trading and currency arrangements constructed with such difficulty over the years since World War II.

14. Assuming that they steer clear of such self-defeating and dangerous means of coping with their difficulties, individual industrial countries, like developing countries, will select differing mixes of "adjustment" and "financing". Certainly, the three concepts of "adjustment" outlined in paragraph 7 are as relevant to them as to the developing countries. However, as industrial countries consume a very large proportion of the world's production of primary energy, perhaps their greatest contribution to an alleviation of the present strains in the international economic and financial system lies in measures to conserve energy and encourage new sources of production. It is now generally recognized that domestic energy prices should be allowed to rise at least to international market levels. Beyond this, the fact that the common interest in reducing energy demand and increasing supply exceeds the sum of individual national interests provides itself a strong justification for collaborative arrangements to further these objectives.

15. In another area of policy, governments and central banks in the major industrial countries should do whatever they can to facilitate access by LDCs to their capital and money markets. They should review existing regulatory or informal constraints, particularly those which have the effect of limiting access to bond markets. They should avoid the imposition of restraints on the international operations of their commercial banks and other financial institutions for balance-of-payments reasons. Countries

with well-developed money and capital markets, in particular, should encourage greater two-way flows of capital (financing longer-term outflows by shorter-term inflows), allowing some of the "maturity transformation" currently effected by banks to be effected in other ways, e.g. by inflows into government paper and outflows through direct or portfolio investment.

Finance Through the Market

16. As in the 1970s, the principal channel of intermediation for the higher income LDCs will be provided by the commercial banks. The flow of market financing will, however, continue to be subject both to "external" and "internal" constraints. The first concept refers to banks' readiness to extend further credit, and depends crucially on the effectiveness of the measures countries take to maintain their creditworthiness. The second concept refers to "prudential" constraints on banks' ability to increase their lending and includes, for this purpose, rules imposed by bank managements and by bank supervisors.

(a) The role of creditworthiness

17. As explained above, some fortunately-placed countries may be able to maintain their creditworthiness without sacrificing growth and in our view market finance will generally be available to such countries provided they adopt the policies that are required to make this approach effective. Others will have to accept restraints on growth—whether temporary or longer-lasting. In all cases, financing and adjustment should go together. Developing countries which act most promptly and effectively to improve their performance (in accordance with the requirements of their situation referred to in paragraph 8) will be able to command a larger volume of financing and be able to run larger deficits later than those that delay such action. Countries that avoid adjustment as long as possible and resort to the maintenance of consumption by financing will ultimately—even if the requisite finance is forthcoming in the short term—weaken their creditworthiness and be forced to an even more painful adjustment in less favorable circumstances. Thus, the relative strength and promptness of the measures adopted by different countries—together with their native resource endowments—will largely determine the distribution of the available financing. However, even the prompt adoption of appropriate policies will bear fruit only over a much longer period than has typically been the case with adjustment programs in the past. So longer-term financing will also be required.

18. Since banks' readiness to extend further credit depends on their judgment about individual countries' ability to service the debt, they will also take into account existing levels of indebtedness. The outstanding public and publicly guaranteed medium and long-term external debt of non-oil developing countries at end-1979—close to $250 billion—was well over three times the total at the end of 1973; as a proportion of estimated aggregate GDP, it had risen from less than 14 per cent to 18½ per cent over the period (IMF "World Economic Outlook", May, 1980). At end-1979, about half the total was owed to private creditors. However, thanks to the rapid increase in export earnings of non-oil developing countries, the rise in annual interest payments has not greatly exceeded that in export receipts. Including estimates for private medium-term debt, the overall debt service ratio (to exports) of non-oil LDCs has increased from about 12 per cent in 1973 to 15 per cent in 1980. The ratio changed little in the two years to end-1979; and the significance of any particular debt service ratio is debatable. Although banks will clearly continue to be selective in their loan policies, there is little reason in our opinion to fear that modest increases in recorded debt service ratios are likely in themselves to inhibit lending to non-oil LDCs that maintain their creditworthiness by means of policies such as those outlined above.

b) "Internal" constraints on bank lending

19. Turning to "internal" constraints, at present there are widespread doubts about the ability of banks to assume as large a share in the recycling of the surplus OPEC funds as in the past. These relate to concerns over capital adequacy; portfolio limits and the concentration of bank lending to a few countries; and the changing attitudes of supervisory authorities. Due to these influences, and prospects for greater competition for funds from OECD countries and possibly China, financial markets are expected to become tighter and borrowing conditions less favorable; thus far, a few LDCs have faced a substantial tightening of terms, though others are still able to borrow on very fine terms. The Study Group is conducting a survey of opinion among leading bankers to enable it to form a judgment on these issues; the following remarks offer some provisional comments.

20. The evidence examined by the study group thus far suggests that these "internal" constraints will not be so restrictive as to prevent a continued rapid growth in lending to developing countries. According to projections made by the IMF, quoted in a speech by the Managing Director, market growth of 20-25 per cent in 1980 and 1981 would yield net international banking flows broadly in line with aggregate borrower demand.*

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*Address to the Federal Association of German Banks, Bonn, October 29, 1980.

This is below the average growth in international bank lending during the last decade. Both the scale of imbalances and the incremental demand for private finance are smaller in relation to the size of the markets than was the case in 1973-74. The study group has not been able to find firm evidence to support the view that capital ratios of international banks in general have deteriorated markedly, or that concentration of lending in a few countries will inhibit the aggregate flow of finance. True, individual borrowers may be affected—that is the function of such constraints. Such countries should seek opportunities to diversify their sources of finance. But as Mr. de Larosière pointed out in the speech mentioned above, taking the banks in the BIS reporting area as a group, neither the share of loans to non-oil LDCs in banks' gross external assets nor the share represented by the dozen largest borrowers has increased in the last several years. The outstanding debt of banks to non-oil developing countries of $190 billion was equivalent to only about 4-5 per cent of total bank assets at the end of 1979.

(c) Market imperfections

21. Other concerns relate not so much to the readiness or capacity of the markets to cope with a substantial further rise in international lending but rather to imperfections in the operations of the markets. For instance, from time to time marked fluctuations have been observed in the credit activities of the commercial banks vis-a-vis the developing countries. At times, commercial banks, spurred on by competition, may lend excessively to certain countries, based on an unduly optimistic appraisal of their prospects or particularly favorable short-term profit opportunities. Some years later, they may suddenly cut back their credits as clouds gather over a country's prospects. Another aspect of this kind of behavior is the tendency for the maturities available in the market to change somewhat abruptly, resulting in a "bunching" of amortization payments due in some years. Such waves of optimism or pessimism can exacerbate the financing difficulties of developing countries as a group, and they can lead to acute difficulties in the case of individual countries.

22. It is important in this area to distinguish the basic operating mechanism of credit markets from the imperfections of these markets. As long as a large part of the flow of capital reaches the developing countries through the banking system, this flow will depend on the banks' views as to what are safe and profitable lending opportunities and the actions of the countries concerned to maintain their creditworthiness. In the relation between the IMF and capital importing countries, there can be direct

negotiation on policies; no comparable mechanism is available between the bankers and the same countries. Perhaps as a result, the market may at times operate in an unduly abrupt way. But, whatever the imperfections and the lack of smoothness of credit markets, these markets perform a basic function. The mechanism of these markets does convey to governments the broad views of the banks on the appropriateness of prevailing policies from the point of view of countries' creditworthiness. Moreover, governments themselves are quite often well aware of policy changes that are called for.

23. The need for futher improvement of the means of communication between the banks and governments of borrowing countries underlines the importance of a continuing flow of authoritative information and analysis about the economies of these countries, and in our view international institutions can play a valuable role in this regard, as outlined below. Moreover, the increasing tendency for the commercial banks to suggest that countries in difficult circumstances enter into policy discussions with the Fund should serve to improve the functioning of the international credit mechanism.

24. Another worry, often expressed but rarely defined precisely, relates to the possibility of some kind of "breakdown" in the recycling mechanism. A break in confidence could arise from a variety of circumstances, some of which may have no connection with LDC indebtedness. But if a number of large or medium-sized debtors were to request debt restructuring within a short period, and interest payments on outstanding debt were to fall below the cost of carrying these loans to the banks, the possibility of a break in confidence would clearly be increased. Heightened uncertainty, reflected possibly in magnified form in the interbank market, could lead to the withdrawal of deposits from banks believed to have large loans (in relation to their total balance sheets) to the country or countries concerned and an atmosphere of "contagious mistrust" engendered. Even in the absence of a "discontinuity" in the interbank market, a debt moratorium by a large borrower--or simply a perception that political risk had increased--would result in more stringent conditions and terms being applied to other borrowers, and possibly to new international loans in general. In a mild form, this indeed was witnessed in 1980, as a result of the revolutions in Iran and Nicaragua. In a wider crisis, there might be a danger of a cumulative process being set in motion which, once under way, might be very difficult to bring under control.

25. True, it is unlikely that any large borrower or group of countries would deliberately take measures that would have the effect of imperilling their creditworthiness. The stake that borrowers have in their continued access to market finance provides a powerful buttress to the continued orderly functioning of the international banking system. Borrowers can be expected to make every effort to maintain at least their interest payments on outstanding debt, even in very difficult circumstances. In the future, as in the past, a number can be expected to request a restructuring of their debt payments, but again this will usually be effected by negotiation with creditors.

26. Nevertheless, in view of the magnitude and speed of recent movements in payments imbalances, and the degree of "maturity transformation" required of the banking system, it would be foolish to deny the possibility, however remote, of a breakdown in the recycling process. On our view, it is an inherently unsatisfactory characteristic of the system that it relies heavily on the "transformation" by banks of short-term deposits into effectively long-term loans; but given the preferences of OPEC depositors and of LDC borrowers the problem is not likely to go away. Also, in the context of volatile oil prices, sluggish growth in the industrial countries and high interest rates, pressures exerted through the markets on borrowers for early progress towards adjustment of payments imbalances may become so acute as to be politically or socially intolerable. In short, there are default risks in international lending; in our view, these risks are increasing.

(d) Prudential supervision

27. The responsibility for providing official mechanisms for the system, to maintain confidence, rests with central bankers on the one hand and the International Monetary Fund on the other. With respect to the former, we recognize the progress made in cooperation amongst central banks and bank supervisors in recent years. The confidence crisis following the failure of the Herstatt bank in the summer of 1974 led directly to the statement issued by the Bank for International Settlements later that year, which, inter alia, stressed the importance that the Governors attached to effective supervision. Further work led to the so-called "Concordat" of 1975, which laid down in some detail the principles on which responsibility for the supervision of bank branches, subsidiaries and consortia should be allocated as between home and host countries. Since then the banks, in cooperation with national supervisory authorities, have moved to strengthen standards of bank management further, and a continuous exchange of views among authorities has taken place in the Committee on Banking Regulations and Supervisory Practices (the "Cooke Committee").

28. These consultations were reflected in the press communique issued by central-bank Governors of the Group of Ten and Switzerland on April 15, 1980. This emphasized the high priority the Governors placed on bringing into full effect the initiatives already taken by the Committee on Banking Regulations and Supervisory Practices with regard to the supervision of banks' international business on a consolidated basis, improved assessment of country risk exposure, and the development of more comprehensive and consistent data for monitoring the extent of banks' maturity transformation.

29. In our view, it is clear that central banks can function as credible lenders of last resort to the system only if they equip themselves to judge the prudence with which individual banks conduct their business; and the knowledge that supervisory authorities take an active interest in the soundness of the banks under their guidance constitutes a valuable contribution to the soundness of the system as a whole. On the other hand, bank supervision should not be used as an instrument to regulate the aggregate volume of international lending. Supervision should lead to the establishment of widely-agreed prudential guidelines; it should involve exchanges of information between bank supervisors; and it should also provide for cooperative procedures to defuse a crisis. Beyond these areas of agreement as to the scope for the supervision of the banks' foreign lending activities, discussion revealed a range of opinion. One view is that supervision could encompass the establishment of individual country debt limits where this seemed necessary to the supervisors; others maintain that banking supervision is a matter of ensuring prudential behavior by individual banks and that it is in this context that supervisors' interest in appraising country risk should be placed; others hold the view that even this would involve unwarranted interference both with the banks' own responsibility for the quality of their loan portfolios and with the effective working of the recycling process. Another study group of the Group of Thirty is examining this and other aspects of banking supervision and risk.

30. From time to time, bankers and their customers in developing countries have expressed concern that unnecessarily "fussy" regulations could hamper the smooth operation of the recycling process. In general, national supervisory authorities should bear in mind the probable repercussions of new regulations and guidelines, even where these are aimed primarily at strengthening their domestic banking structures, for inter-

national financial flows, and particularly for flows to developing countries. Such difficulties may be alleviated if regulations which could have far-reaching repercussions could be introduced gradually, and interpreted flexibly in the initial stages. This could apply, for instance, to movements in the direction of global capital ratios. Abrupt changes in the regulations imposed by some national authorities on their banks' activity in the international markets have occasionally had an appreciable effect on market conditions generally. It would be desirable to avoid such abrupt changes in the future.

(e) Relations between the banks and the Fund

31. Another complex set of issues surrounds the relationships between commercial banks, supervisory authorities and the International Monetary Fund when a country agrees an adjustment program with the Fund—and particularly when some rescheduling of debt is involved. If the Fund's resources are to provide a net addition to the total resources—private and official—available to a country in need, it is highly desirable that, when the Fund extends credit, private creditors should be willing to maintain their exposure or, at the least, that they should not withdraw an equivalent amount. Indeed, the Fund and the borrowing country will normally look for a further net inflow from private sources; one of the most valuable functions of the Fund is clearly its ability to negotiate conditions for access to its resources, and its role as a "catalyst" in attracting private flows is an important reason for the conditions on which it insists. The commercial banks recognize that they as well as the country concerned benefit greatly from the fact that an institution exists capable of performing functions that they cannot fulfill. They will also wish to avoid political allegations that they are being "bailed out". So the banks should be prepared to maintain some level of exposure that, as a minimum, provides the country with a net increase in the total external resources available to it. On the other hand, conditions attached by the Fund to its lending will need to be sufficiently stringent to encourage an adequate flow of credit from private sources (this subject is discussed further in paragraphs 39, 40 and 44).

The Role of the Fund

32. Given the need to achieve a proper balance between adjustment and financing, a crucial role devolves upon the International Monetary Fund. The manner in which it functions will be crucial to the stability of the system and will require the availability—and indeed the use—of resources

on an unprecedented scale. The necessity for the Fund to be able to provide large resources arises from two interrelated causes:

(a) Individual countries, small or large, may find themselves in intractable payments positions with an obvious need both for the adoption of adjustment policies and for finance to make the transition to a sustainable situation politically bearable. Only if the Fund can proffer finance on a substantial scale to a country in such circumstances, can it effectively encourage the adoption of constructive policy changes. It may be hoped that the Fund's assistance will unlock capital flows through the market; but reliance cannot be put on market flows alone, and the resources that the Fund can make available need to be large enough to give a country's adjustment program a fair start.

(b) The risks are not exclusively with the policies of individual countries. As outlined above (paras 24 to 26), in a world characterized by the presence of massive and violent shifts in the distribution of these imbalances, there exists a risk that important links in the "recycling" mechanism may break down, with possibly wider consequences. In such circumstances, the Fund must be ready to support the solidity of the system. The Fund must therefore be able to fulfill a contingency function which may be crucial and the magnitude of which is quite impossible to forecast.

33. The case for a larger role by the International Monetary Fund does not rest, therefore, on calculations of a "gap" between the likely scale of private flows and the "needs" of developing countries in general. If the system runs smoothly—thanks in part to the Fund's operations with individual countries—such a gap may never arise. But the Fund's operations with individual countries—in particular, if some of these are large countries—will involve very sizable amounts, in any event. The Fund could make its greatest contribution to the adjustment process and the solidity of the system by concentrating its assistance on countries engaging in major adjustment programs. In this manner, the Fund would avoid merely replacing lending to countries that have access to the markets.

(a) Financing growth in Fund resources

34. The resources that the Fund can use can essentially come from two sources, quotas and borrowing. The Fund's Interim Committee has stressed that the Fund should continue to place primary reliance on subscriptions under members' quotas as a source of financing the Fund's operations. The Study Group shares this position. Unfortunately, quota increases have not kept pace with the growth of members' international

transactions, and even less with the growth of payments imbalances. Even with the recent 50 per cent increase, aggregate quotas amount to only some 4 per cent of members' imports, as against 10 per cent in 1970 and even somewhat higher percentages in the 1960s. The Executive Board of the Fund is making an early start on the next (the Eighth) quinquennial review of quotas; but the results of that review, whatever they may turn out to be, are unlikely to become available much before the middle of this decade.

35. There is no question, therefore, that the Fund will have to take recourse to borrowing if it is to provide its members with assistance on a scale commensurate with the size of the problems they are likely to incur in present circumstances. In the 1970s, the Fund arranged twice to borrow from oil exporters and from some industrial surplus countries—about SDR 7 billion under its Oil Facility in 1974-75, and, more recently, about SDR 8 billion under the Supplementary Financing Facility. The money that was available to the Fund under the latter facility has already been committed, so that arrangements for new loans are clearly required. These may again be obtained from surplus countries, or the Fund might tap the capital market or use both sources. Borrowing from surplus countries would use an established technique and could be for very large amounts from a small number of official creditors; market borrowing could take the form either of credits from large commercial banks, or of public issues. Market borrowing raises a number of technical issues with which the Fund has not had to deal in the past. But it also has the special attraction that any arrangement that the Fund could conclude in the market would be purely commercial. Moreover, the establishment of a commercial market for Fund issued paper, in which surplus countries might acquire substantial amounts of such paper, would benefit official holders because it would provide enhanced liquidity for the claims held by them. At the time of going to press, the Fund was making plans to obtain lines of credit amounting in total to SDR 6 or 7 billion this year, and further amounts in 1982 and 1983. In our view, such borrowing, amounting in total to some $20 to $25 billions, may well be required over this three-year period.[1]

36. The Fund's financing activities are likely to lead to a considerable increase in the volume of SDR-denominated claims in the monetary system. The Fund's credits to its members are, in effect, denominated in SDRs, and the resources the Fund uses to extend such credits (i.e., the

[1] As this publication was being passed for press, it was announced that the Saudi Arabian Monetary Agency has agreed in principle to lend SDR 8 billion to the Fund over the next two years. It was expected that the agreement would be finalized in May, 1981.

liabilities of the Fund that match its assets) are similarly expressed in SDRs. Insofar as the Fund uses contributed (quota) resources, this follows from the Fund's Articles of Agreement; insofar as it uses borrowed money, the SDR denomination is a standing practice of the Fund which safeguards it against running an exchange risk in its transactions. The consequence of these arrangements is that the large expansion of Fund credit which is likely to occur in the next few years will create a corresponding increase in SDR-denominated assets held by countries with creditor positions in the Fund and by lenders to the Fund. To acquire these SDR positions, countries will generally have provided currencies, most likely US dollars, to the Fund. It is clear, therefore, that the Fund's credit operations will—as a by-product—have certain effects that have much in common with those envisaged for a "Substitution Account."[1] Countries with ample reserves will be able to exchange a portion of their dollars for SDR-denominated claims on the Fund. These claims may resemble the SDR claims envisaged for the substitution account in a number of other respects: e.g. they may be transferable, and earn a floating interest rate linked to the market interest rates on the five component currencies in the SDR basket (US dollar, DM, Pound sterling, French franc, and Japanese yen). But although the Fund's credit activities are likely to be large, and will thus perform some of the task of off-market diversification for which the plan for a substitution account had been designed, they cannot be expected to reach the scale of SDR 50 billion over a five-year period envisaged for that account.

(b) The cost of borrowing from the Fund

37. With respect to the cost of borrowing from the Fund, resources made available from quota subscriptions reflect the cooperative character of the Fund. The creditor countries whose currencies are used receive less than the full market rate on their contributions, and this permits the Fund to lend these resources at less than market rates. For borrowed resources, the Fund will have to pay approximately market rates. Even though such rates will no doubt reflect the superior credit standing of the Fund, the Fund has to charge considerably more when on-lending borrowed money than when it lends its own resources. For countries whose alternative source of finance would be the Euro-markets, even borrowed Fund money would still come somewhat cheaper than market resources. But for the low-income developing countries, borrowed money passed on by the Fund will clearly become too expensive.

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[1] For a discussion of the concept of a substitution account, cf. an earlier policy paper of the Group of Thirty, "Towards a Less Unstable International Monetary System" (New York, 1980).

38. In part, the response to this problem will have to lie in the provision of grants and low-interest loans to these countries to assist them in staying on their development paths. But the Fund itself can provide relief to the extent that it has resources to subsidize the interest rates that it has to charge. To this end, the Fund established, in late 1980, a subsidy account to reduce for low income countries the effective interest cost of resources borrowed by the Fund under its supplementary financing facility. It is hoped that this account will attain SDR 1,000 million. Part of its resources are to come from voluntary contributions by countries that are in a position to give foreign aid in this form. Fortunately, the Fund has a further source of money on which to draw for the subsidies: the profits on the sale of part of its gold over the past four years that were lent out as 5 to 10 year low-interest loans to low-income developing countries (an amount of close to $4 billion) and which will soon begin to generate a flow of repayments. Of these repayments, SDR 750 million will flow into the subsidy account. The Fund has, however, no arrangements to reduce the cost of money borrowed under its more recent borrowing arrangements. Moreover, the Fund appears to have concluded against further gold sales in the market, thus maintaining its still very substantial gold holdings (over 100 million ounces, worth $50 billion at a gold price of $500 per ounce) as part of the asset structure in its balance sheet, to bolster its ability to borrow.

(c) Conditions for access to Fund resources

39. The ability of the Fund to perform the functions that are called for in present circumstances does not only depend on its ability to attract sufficient resources. While the modalities of further quota increases for the Fund, and especially of its borrowing on a much larger scale than it has done so far, naturally raise many problems, there can be little doubt that these problems can be overcome and that an institution with the international backing and the assets that the Fund commands should be able to acquire the resources necessary for its task. The more difficult issue before the Fund is whether it will be able to submit its lending activities to conditions that will meet the twin tests for its success: that countries in need of adjustment action will come to the Fund for its assistance, and that the nature, the intensity, and the speed of adjustment on which the Fund insists will be sufficient to restore, over time, the economic and financial viability of the countries that draw its resources. The Fund is, in this respect, faced with a clear dilemma: if its conditions are too rigorous, countries may have recourse to highly undesirable restrictive policies, rather than come to the Fund; if they are too loose, the Fund resources may be poured into situations that fail to be remedied, countries' credit-worthiness will not be restored, and the Fund's credit may, in fact, prove to be frozen.

This dilemma is commented upon further below (paras 44-45).

40. It is clear from what was just said that conditionality is an indispensable element in the Fund's operations. It is no service to a country—or any other borrower—to allow or encourage an increase in the burden of indebtedness beyond its capacity to service that debt. It is in a country's own interests—though not necessarily in that of the government of the day—to restore its economic and financial viability as rapidly as possible. It is also in its own interests to maintain its access to other sources of finance, and these may be forthcoming only if the country negotiates a program of adjustment with the IMF. From differing perspectives, both the markets and the Fund now provide a cushion against external shocks. In the words the Fund used of its own operations many years ago, both the markets and the Fund provide "time, but not time to waste".

(d) Closer association between the Fund and its members

41. In recent years, with the much wider development of credit through the international banking system, there has been an increasing tendency that only members in the most severe difficulties would use the Fund, which has thus tended to become a lender of last resort. True, there have always been a number of commendable exceptions—countries that have maintained standby arrangements as a normal part of their financial management. But if the Fund is to continue to perform its functions in an efficient way, it remains desirable that countries come to it before their problems have become virtually intractable; and there have been some

New Loan Commitments and Other Use of Fund Resources
(billion SDRs)

Calendar Year	1973	1974	1975	1976	1977	1978	1979	1980
1. New Loan commitments under stand-by and extended arrangements in period	0.4	1.4	1.2	0.9	5.2	1.9	2.2	7.2
Industrial countries	—	*1.0*	*0.8*	—	*3.8*	*0.1*	—	—
Developing countries	*0.4*	*0.4*	*0.4*	*0.9*	*1.4*	*1.8*	*2.2*	*7.2*
2. Other uses[1]	0.2	1.9	3.6	4.6	0.3	0.7	0.7	1.0
Industrial countries	—	*0.8*	*1.5*	*1.7*	—	*0.1*	—	—
Developing countries	*0.2*	*1.1*	*2.1*	*2.9*	*0.3*	*0.6*	*0.7*	*1.0*
3. Trust Fund loans disbursed (developing countries only)	—	—	—	—	0.2	0.7	0.5	1.3
Total (1 + 2 + 3)	0.6	3.3	4.8	5.5	5.7	3.3	3.4	9.5

[1] Mostly drawings under the compensatory financing and oil facilities.

indications in recent months that a change in this direction is under way. Indeed, greater use of Fund resources has already been reflected in the statistics of new loan commitments and other use of Fund resources. As the accompanying table shows, there has been a very sharp increase in new loan commitments under programs of one to three years, and if these are combined with balance-of-payments assistance provided by the Fund outside such programs, a total of SDR 9.5 billion was committed or used in 1980, compared with SDR 3.4 billion in 1979.

42. We believe that further progress in encouraging countries to come to the Fund at an early stage in their payments difficulties could be promoted. In particular, the Fund could develop its Article IV Consultations to generate a continuous understanding with each member on the adequacy of its policies. Such an understanding could serve to facilitate, and thereby to compress in time, the negotiations that would be required to reach agreement on a standby arrangement in case of need. One step that could be considered in this connection would be to give publicity to the results of the annual consultations whenever the country concerned wanted this. The Fund could, in those circumstances, release its views on the country's policies, which might convey a broad approval of these policies, but also specify areas in which the Fund had reservations. The mentioning of such reservations would, at the same time, point up publicly areas in which changes would probably be necessary if the country wanted to conclude a standby arrangement with the Fund and might strengthen the hand of the government to bring about such changes. Public knowledge about the extent to which the Fund was prepared to endorse a country's policies would certainly assist the banks in their appraisal of the country. However, it should also be recognized that publication could raise political difficulties for the government of the country concerned and that governments' apprehension of this might even lead them in some circumstances to withhold confidential information that they now give to the Fund.

43. A closer association between the Fund and its members through more intensive use of the consultations procedures would reduce the risk to which the international financing mechanism is exposed, and it would also be likely to improve the adjustment process, even if such association did not lead to a very large volume of Fund transactions. While the commercial banks have performed an outstanding recycling job, there are certain tasks in the international adjustment process that are beyond their reach but which the Fund can perform, in addition to its financing function. The Fund is in a position to monitor the performance of members'

economies. In its consultative role in the context of Article IV, its periodic inquiries into the policies of member countries are likely to act as a wholesome constraint even where no specific limits (e.g., on credit expansion) are agreed with a country. Moreover, the Fund's analysis of global economic interrelations is essential both as a background for members' policies and for its own effective operation, and its ability to perform these functions is critically dependent on its thorough understanding of the conditions and the policies of its member countries.

44. Where countries do require finance, there is a strong case for arguing that the Fund should stand ready to provide conditional assistance on a larger scale and over a longer period than in the past. To fulfill its function of safeguarding the stability of the system, and maintaining the progress made in the past generation towards an open world currency and trading system, the Fund should be prepared to take greater risks than private lenders can justifiably assume. Assistance on a larger scale (in relation to quotas) than in the past is needed because of the size of current imbalances and the risk of a breakdown in the recycling mechanism; over a longer period, because (as already noted) the kind of adjustment called for by the adverse change in countries' external circumstances will often require increasing investment, and effecting "structural" changes, which bear fruit only over an extended period.

45. The Fund has indeed modified its practices along these lines. It has adopted a guideline for the amount of assistance it is willing to grant of 450 per cent of the (recently-increased) quotas over a three-year period, with annual limits of 150 per cent of quotas and an upper limit on credit in the credit-tranches of 600 per cent of quotas, a sixfold increase over the 100 percent of quota limit over any period of time normally applied until a few years ago; it has shifted its emphasis from one-year to three-year credit arrangements; and it has lengthened the maximum period of repayment under the "Extended Fund Facility" from 8 to 10 years. All these changes have the effect of mitigating the dilemma (referred to in paragraph 39) that the Fund faced. First, if a country can obtain assistance from the Fund on a much larger scale, this improves its cost-benefit trade-off for using the Fund's resources. And second, increased financing over a longer period of time makes it possible for the country to reduce the extent of the adjustment necessary in the first year of an arrangement with the Fund while, at the same time, committing itself to a course of action that can be expected to achieve the needed adjustment over time.

46. Because of the multi-faceted nature of the adjustment process that many countries face in present circumstances (see paragraph 7 above), the Fund's approach in the field of adjustment will also have to be broader than that on which it placed its main emphasis in the past, viz., the correction of inadequate financial policies. Action in this field will still be needed in the cases where such policies are a major cause of a country's payments difficulties. But other policy changes may be needed in almost all countries that come to the Fund for assistance in order to adjust their economies to the three fundamental changes in the economic environment: slower growth in the industrial world, the sharp increase in energy prices and the move to positive real interest rates. These latter policy changes lie generally in the area of supply (of new commodities for export, of alternative sources of energy, etc.). Hence, to assure itself about the general creditworthiness of the countries it assists, the Fund will need to concern itself with supply policies, not in substitution for, but in addition to, its concern with demand policies. It is obvious that in dealing with policies on the supply side, the Fund approaches the area of competence of the World Bank, just as the World Bank approaches the Fund's field of activity by extending its lending activities to "structural adjustment loans" (see paras 55-57 below). These convergent changes in the activities of the two institutions call for close collaboration between them, and there are welcome signs of developments in this direction.

(e) Help for the poorest countries

47. In the previous paragraphs, much attention has been focused on the role of the Fund as a backstop or a lubricant of the framework of a recycling process consisting largely of flows of private capital. This is indeed the largest component of the flow of capital to LDCs. But these flows are directed to the more fortunate of the developing countries, those that have established access to the international money and capital markets. It is equally urgent to devote attention to the difficult payments problems of the poorest developing countries, which—generally speaking—are not in a position to have recourse to private credit when faced with payment difficulties. These countries do not provide the examples of crises of overborrowing, followed by massive rescue actions, of the last decade; they cannot borrow what they need, let alone beyond their needs.

48. For these silently suffering countries, the IMF is the main source of balance-of-payments credits, and the willingness and ability of the Fund to assist these countries on an adequate scale, and on terms they can afford, is one of the keys to smooth progress of their development. Equal-

ly—perhaps even more—essential for these countries, which cannot rely on the world's financial markets for their development capital, is the provision of an adequate and increasing flow of concessional aid. The problems of these countries are considered further in paras 75 to 78 (see also paragraph 38).

(f) SDR allocations

49. There is one further respect in which the Fund contributes in a modest way to the alleviation of the debt problems of the developing countries. These countries, like other countries, feel the need for a trend increase in the level of reserves that they maintain broadly in line with the secular rise in the value of their international transactions. The acquisition of these reserve increases through the market mechanism involves, directly or indirectly, an increase in foreign borrowing and hence-even if the additional borrowing can be arranged without difficulty—the use of some portion of a country's access to credit, which is by no means unlimited. To the extent that the Fund meets the needs of its members for increases in reserves through the annual allocation of SDRs, countries can preserve their access to credit and, incidentally, also acquire reserves at a somewhat lower interest cost. In its decisions on SDR allocations the Fund must obviously take account of any inflationary risk to which it would expose the world economy if it were to set the annual figure too high. Amounts in the order of magnitude of those allocated in 1979 to 1981, SDR 4 billion per year of which about SDR 1 billion went to the non-oil developing countries, could hardly be faulted on that ground.

The role of the World Bank

50. The major contribution of the World Bank in current circumstances is to help developing countries sustain the momentum of their economic development, so far as possible, despite the adverse change in their external environment. It makes this contribution by way of both project and non-project lending and through its non-financial, advisory role. One of its main strengths is its ability to draw upon an extensive operational experience and to associate advice with a willingness to provide substantial finance. However, its capacity to maximize its potential contribution is a present limited by a growing shortage of resources and by policy guidelines adopted by the Executive Board.

(a) Energy-related investments

51. The importance of the World Bank's project financing in helping to sustain investment is perhaps clearest in energy-related investments.

The price of oil in real terms is now more than five times what it was in 1972. This shift in relative prices applies to all forms of energy and has thus altered investment priorities in a wide range of sectors; these include not only the commercial exploitation of primary energy resources, but also the production and use of traditional fuels (notably wood), as well as transport systems and the use of energy in existing industrial plants.

52. The very large energy investments which lie ahead in the developing countries have led to the proposal that the World Bank should further expand lending plans in this sector. A World Bank report published in August 1980 described in some detail an expanded lending program totaling $25 billion over a five-year period, a near doubling of its current lending plans for energy.

53. An expanded program of energy-related financing would contribute directly to the reduction of world energy imbalances and thus strike at a root cause of the recycling problem. It is estimated that additional production and energy savings associated with an expanded investment program over the next five years could save the developing countries something on the order of three million barrels of oil-equivalent a day once these projects are fully on stream. Indeed, such an effort may be essential to the oil-importing countries' hopes for continued economic growth, since the balance-of-payments savings attributable to three million barrels a day of oil equivalent could reach $40 billion a year (in 1980 prices) by 1990.

54. As a vehicle for financing expanded energy operations the World Bank has been investigating the establishment of an energy affiliate. The affiliate would be market-based in the sense that only a minor part of its resources would represent budgetary outlays by governments. Most of the resources would be borrowed either from the various capital markets or directly from governments. We believe that direct borrowing from surplus countries would be a constructive contribution to the recycling process and should be pursued. It would also be desirable for the surplus countries to have a major stake in the equity of an affiliate. In fact, this may be an important incentive to these countries to agree to substantial direct loans to the affiliate. Despite continuing difficulties in establishing an affiliate, we believe that the need to foster the development of energy resources in developing countries is sufficiently urgent to justify the Bank giving a high priority to its plans in this area, possibly by opening a new "energy window". Assistance provided by the Bank under such a program would be complementary to investment by the private sector and governments.

(b) Balance-of-payments adjustment financing

55. While project investments in energy have a direct and immediate link to the recycling problem, the balance-of-payments pressures caused by the shift in most developing countries' terms of trade and by the slower growth in their traditional export markets have greatly increased the external financing requirements needed to support domestic economic growth in these countries. This by itself would seem to call for some increase in the intermediation role played by the World Bank and the regional development banks. However, increases in planned project lending will not add significantly to capital inflows over the next year or two. The volume of external resources to be provided by the World Bank in this form over this period is already largely determined.

56. To help the developing countries cope with their immediate balance-of-payments deficits in a way which minimizes the penalties to their longer-run development and growth objectives, the World Bank recently decided to supplement its traditional project lending with so-called *structural adjustment loans*. These loans support programs designed to increase the efficiency of resource use and to re-orient production and trade patterns so as to achieve a viable balance-of-payments position within a few years. Commitments of this kind might amount to $800 million in the current fiscal year (ending June 1981) and could rise substantially in later years.

57. These amounts are small in relation to the financing problems of the developing countries. Nevertheless, to the extent that structural adjustment loans are associated with changes in domestic policies which promise greater efficiency in domestic resource use, they can form the basis for expanded capital flows from private sources.

(c) Collaboration with the Fund

58. The World Bank's role in lending for structural adjustment is clearly complementary to that of the IMF. Indeed, the two institutions have typically collaborated quite closely in cases where the imbalance needs to be corrected over an extended period through a combination of fiscal and monetary restraint with specific measures to encourage reallocation of resources into exporting or efficient import-substituting activities. The Bank's ability to commit somewhat longer-term funds and to advise on sector-specific resource allocation issues complements the IMF's established role and its ability to mobilize short and medium-term financing.

59. The established collaboration between the two institutions is likely to ensure that structural adjustment loans given by the Bank will fit into the

pattern of financial adjustment to which the Fund pays primary attention and that Fund assistance under the Extended Fund Facility will pay adequate attention to required changes on the supply side on which the primary experience lies with the Bank. No doubt the amounts made available by the two institutions will be coordinated. There is little risk therefore that the Bank and the Fund, in implementing their rather similar facilities, will either duplicate each other's efforts or operate at cross purposes. There does remain a question, however, whether—now that each institution has become fully convinced of the need for the observation of both supply and demand conditions in almost all cases—it remains useful for both to provide resources for what has in effect become a single need of its members.

60. Two criteria are relevant in this connection. The first relates to the aspects of the economy that require structural adjustment. These involve in virtually all cases the country's major financial policies, thus calling for direct involvement of the Fund through an extended arrangement. But in some cases major adjustment in a particular economic sector (eg agriculture) is also needed, which could be assisted by a structural adjustment loan. A second criterion relates to the total availability of funds. It is clear that both the Bank and IDA are encountering extreme difficulties in adding to their flow of resources. This inevitably limits the extent to which the Bank and IDA can give without contracting their other lending activities. On the assumption that the Fund will be successful in marshalling large borrowed resources, that institution will be subject to less financial constraint in providing resources for balance-of-payments adjustment. If these two criteria are followed the bulk of such financing is likely to be performed by the Fund, with financing by the Bank and IDA concentrated on restructuring of key sectors. (There is a separate issue on the extent to which the Bank's and IDA's regular lending should take place as project loans or as program or sector loans; the discussion in this paragraph is not addressed to this issue).

(d) Resource constraints and policy guidelines

61. As noted above, the ability of the World Bank and the regional development banks to expand either their project or their non-project lending in response to the increased financing requirements of the developing countries is limited partly by resource constraints, but also partly by reversible policy decisions.

62. The resource constraints are most acute on the concessional side: that is, the availability of IDA-type resources. As has often been noted, the poorest developing countries are the ones least able to respond to

deterioration in their balance of payments by reducing growth rates or deferring development investments. They are also the ones least likely to obtain financing from private sources: recycling has little meaning to these countries except to the extent that enlarged funds can be obtained from official sources. Essentially, these are the only sources available to them to help them effect a rational and orderly adjustment.

63. IDA is the largest single source of concessional finance for the poorest countries. Yet IDA's new lending operations were brought to a halt in April 1981 because the United States had not ratified the latest replenishment agreement. True, continuing disbursements under prior credits mean that the immediate impact on the poorest countries' balance-of-payments situation is not yet large. But a penalty is already being paid in terms of delays in implementation of new development projects. These penalties will mount rapidly if IDA commitment authority is not restored quickly. The key requirement is that the Congress should promptly ratify the commitment made by the previous Administration and re-affirmed by President Reagan's Administration.

64. The IBRD itself is also subject to resource constraints, partly in terms of its ability to borrow, but more importantly in terms of the availability of share capital subscribed by member governments. This share capital, which is mostly in the form of guarantees of IBRD borrowings, was recently increased by $40 billion. Provided that governments subscribe to this increase (beginning in September 1981), the IBRD will have enough capital to support a substantially higher volume of lending than is currently planned. What stands in the way of exploiting that capacity is not a legal or financial constraint, but rather a policy decision setting IBRD growth at an annual increase of 5 per cent a year in real terms. Were this policy decision to be modified in the light of the IBRD's potential contribution to easing the recycling process, part of the increased lending would go into non-project or sector lending—and thus contribute to the financing of existing payments deficits—but a larger part would go to support investment projects, and thus reduce the extent to which adjustment forces countries' development plans to be held back. We believe that in the present exceptionally difficult circumstances the 5 per cent guideline should be revised to permit expanded lending to take place, particularly in the energy sector.

65. Another factor affecting the Bank's lending capacity is its so-called "gearing ratio". This ratio, which is part of the Bank's legal charter, limits outstanding loans to the total of its capital and reserves. Such a 1 to 1 ratio is very conservative. We recommend that this limit be reviewed.

While such a change needs to be carefully managed so as not to alarm existing and potential creditors of the Bank, we have no doubt that a substantially higher ratio—say, 2 or 3 to 1—would still leave creditors very well protected.

(e) Co-financing

66. Apart from its direct assistance to developing countries' investment strategies, the World Bank also stimulates other private and official capital flows, notably through cofinancing operations. In these operations, funds from the World Bank are "associated" with funds provided by private sources (these private lenders have separate agreements with the borrowers). Including all types of "cofinancing" arrangements, such operations increased from $1.5 billion in fiscal year 1974 to $6.5 billion in fiscal year 1980; cofinancing arrangements with private lenders rose from $85 million to $1.8 billion over the same period. Some commercial bankers have for several years been seeking to persuade the World Bank to do more in this area, particularly by means of strengthening cross-default clauses in co-financing. (At present neither the World Bank nor co-lenders are required to take any further action following a default). To make such provisions significantly more attractive to commercial banks, the present arrangements would need to be changed so that default on a private credit extended under a cofinancing arrangement required the World Bank to commit itself to take further action, such as halting new operations in the country concerned. However, this would probably be strongly resisted by borrowers, thus possibly reducing the volume of co-financing, and would tend to deprive the system of an element of flexibility. Given these realities, the further growth in traditional co-financing is unlikely to be dramatic.

Other Proposals for Assisting Capital Flows

67. A wide variety of other suggestions have been made in recent months for assisting the flow of capital to developing countries. The study group has not been able to examine all of these. Of those it has studied, however, few satisfy the criteria that the proposed scheme should offer prospects of adding significantly to the sustainable net flow of resources to the non-oil developing world, should not jeopardize their longer-term growth prospects and should not interfere with needed adjustment.

68. Many proposals involve the provision of further (full or partial) *guarantees for private loans or credits*. Yet in many respects the system

can be said to be already overloaded with guarantees—guarantees tied to export credits, or other guarantees by governments or official agencies in creditor and debtor countries. In so far as the IMF and World Bank are concerned, the IMF is not empowered to offer guarantees; and guarantees by the World Bank suffer from the objection that the Bank might as well make the loan itself; the same capital backing is needed for Bank guarantees as for its direct loans.

69. Provision of further guarantees (by newly-established official agencies or affiliates or by other organizations) often suffer from other drawbacks. They can easily have the effect of undermining the responsibility of private lenders for appraising creditworthiness, an essential check in the system, and of borrowers, in ensuring that the funds are put to good use. To the extent that they lessen the need for discrimination by lenders they would tend to encourage the overprovision of finance. Ironically, calls for further guarantees are often made by observers who also claim to be very worried about the "over-indebtedness of developing countries". But it is no service to these countries to encourage them to increase their indebtedness to levels that exceed their probable capacity to service the debts. Indeed, one of the reasons why countries have often come to the Fund at a very late stage in their payments difficulties may be that private finance—much of it "guaranteed"—has in some cases been too readily available. The provision of more guarantees on bank lending might only further undermine the Fund's authority. In addition, borrowers themselves may view guarantees as posing some risk to the continued growth of unguaranteed lending.

70. Other proposals are directed towards upholding confidence in the international banking system in times of stress; various arrangements to provide supplementary liquidity to the system at such times might be devised. One suggestion is that a "*safety net*" be established among the major international banks to assure access to liquidity when the inter-bank market is under stress. We recognize the attractions of such proposals but, on balance, we do not think they are likely to be effective in practice. Proposals to structure a safety net on the basis of swap arrangements between commercial banks (drawn along the lines of similar facilities between central banks) suffer from the critical weakness that their effectiveness depends on inter-bank confidence, which is precisely what is lacking in crisis situations. In such situations, only the central bank has the competence to act as 'lender of last resort' and the authority to require acceptance by all parties of its terms.

71. The most logical channel for recycling takes the form of *direct loans and aid from OPEC countries* to non-oil LDCs. The OPEC countries already provide an estimated one-quarter of all aid to the developing world, and two of them, Saudi Arabia and Kuwait, rank among the six largest bilateral donors in absolute terms. The aid is also being distributed more widely than in the early 1970s, as shown by the rapid growth in the number of non-Arab participants to about 65 in 1978; according to DAC figures, of the total official flow of resources to all non-OPEC countries from OPEC countries and Arab/OPEC multilateral aid institutions, nearly 40 percent went to non-Arab nations. Between 1975 and 1980, OPEC's official development assistance totalled between $5 and $6 billion a year, according to OECD figures. In this connection it is encouraging that three oil-exporting countries—Mexico, Venezuela and Kuwait—have recently announced the provision of substantial further low-interest resources to non-oil LDCs. It is to be hoped that this example will be followed by others, so that the risks of lending to non-oil LDC's will be shared more widely by OPEC countries.

72. Various suggestions have also been aimed at increasing the *flow of direct investment* to non-oil LDCs. Support for such flows is provided by *investment guarantee schemes* established by DAC member countries, which offer cover against "political" or "non-commercial" risks, by the IFC, and also by government-sponsored investment corporations established by a number of industrial countries. With respect to these and other proposals the OECD has commented ("Investment in Developing Countries" page 10) that "the possibilities for action on the part of the governments of capital-exporting countries to stimulate the flow of private capital to developing countries are rather limited. However elaborate the incentive measures introduced by donor countries, the major responsibility for the improvement of the investment climate remains with the host countries."

73. One interesting suggestion has recently been made for a mixed official-private guarantee fund to insure the risks of direct investment in developing countries.[1] Shareholders in this fund would be governments and central banks of developed and developing countries as well as commercial banks. The fund would guarantee direct investment projects provided they were found to be commercially viable and fitted into the development priorities of the country in which the investment would take

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[1] Proposal for an "International Credit Guarantee" made by Dr. H. J. Witteveen at *Financial Times* Conference, Sri Lanka, September, 1980.

place but that country would not have to provide a guarantee. The insurance offered by the fund would cover part of the country risks and perhaps also part of the project risks. This proposal has been submitted for consideration to the "Task Force on Non-Concessional Flows" of the Bank/Fund Development Committee.

74. On another matter, we believe that consideration shold be given to means of encouraging greater participation in the international financial markets by *non-bank financial intermediaries*, notably by insurance companies, pension funds and other institutions in the industrialized countries. Such institutions usually invest their funds in government paper, real estate or in domestic stock markets, and their investment policy is often subject to statutory or other official constraints. In addition, developing country access to the US capital market is limited by the New York State restriction that US insurance companies may hold no more than 1 per cent of their assets in foreign securities. The US Treasury has informed the state authorities that it supports the liberalization of the present overall ceiling on foreign security holdings from 1 percent to 2 percent of each company's total assets. While insurance companies may be reluctant to build up their holdings of securities issued by LDC borrowers rapidly, we believe that a further liberalization of the US and other capital markets could open new sources of funds for international institutions, such as the World Bank and even the IMF, if it were to borrow in the markets—sources that would be complementary to existing channels.

The Problems of the Poorest

75. The general development problems of the poorest countries are outside the terms of reference of our enquiry. However, the surge in the real price of energy and the slowdown of economic growth in the industrial countries have occasioned a further significant deterioration in the life chances of the hundreds of millions of people living below the poverty line. What can be done to ease the balance-of-payments problems of the poorest countries, for many of which the term "recycling" is irrelevant because they have no prospect of becoming creditworthy in the markets?

76. We have already outlined the roles that the official multilateral agencies can play (that of the IMF in paras 38 and 47-48 and that of the IDA in paras 61-63). We have also made clear that we think that OPEC

countries should further increase the flow of concessional funds both within and more especially outside the Arab world. Plainly, survival for many of the people living in such countries will depend on a substantial increase in aid, the prospects for which are not good.

77. In view of the bleak prospects for low-income countries, a new approach is needed to the payments problems of these countries. In recent years the ideological gulf between the rich and poor has widened, and UN special sessions as well as debates at the General Assembly have witnessed increasingly bitter criticisms of the existing monetary system in general, and of the roles of international institutions in particular. At the same time, while the prospects for the poorest countries (which carry many votes in such assemblies) have deteriorated, the proportion of total aid flows going to them has not increased substantially. The further rise in the price of oil, of fertilizer and thus of food has been another bitter blow.

78. In these circumstances we believe that the international community should respond by establishing a program under which international institutions (notably IDA and the regional developments banks) would enable countries to finance payments deficits at highly concessional rates of interest (such as ¾ of one percent). The level for each country's deficit could be set, in advance, in the context of an agreed development plan, revised periodically. The additional funds required might not need to be very large in relation to existing aid flows, since they would supplement flows that each country receives from its respective donors. Economically, this might give the governments of these countries better possibilities for planning their economic development, by being assured in advance of being able to finance a given deficit. Politically, such an initiative might help to defuse the ominous trend towards an increase in confrontation between developed and developing countries.

Conclusions and Recommendations

79. Massive shifts in payments imbalances caused by the further escalation of the price of oil and slower growth in the industrialized countries are imposing unprecedented strains on all non-oil developing countries and on the international financial system. The broad conclusion of our study is that these strains are manageable, but they have to be managed and not just left to chance. In this respect the current degree of concern with the functioning of the system shown by governments, central bankers, the international institutions and commercial bankers is itself

healthy and welcome. This concern needs to be focused, however, and translated into action, or contingency planning, to support indentifiable weak points in the system, rather than left floating as an undifferentiated cloud of anxiety. For unreasoned anxiety could itself cause any problems that arise to snowball quite unnecessarily: to a greater extent than ever before, the viability of the system rests on the maintenance of an adequate degree of confidence.

80. Throughout this study we have been concerned to identify such weak spots, and to propose what we believe to be practicable responses. Many other proposals have been made from time to time, but many of these are in our judgment not practicable or not advisable (such as proposals involving a further indiscriminate extension of guarantees on bank loans). Various sections of this study have offered suggestions directed to governments, central banks and banking supervisors, commercial bankers and international institutions. The following is an attempt to summarize the main points made.

Governments

81. (a) In their own interests, countries should adjust as rapidly as is economically and politically feasible to the adverse change in their external circumstance brought about by the further rise in the oil price and slower growth in their main export markets. Adjustment cannot be avoided indefinitely by recourse to financing, even if much larger flows of official financing were to be available.

(b) The nature of the change in external circumstances will call in most cases for adjustments both in the area of demand management and in other policies affecting conditions of supply. The principal objectives in the latter case should be to raise levels of domestic investment generally (i.e. to take further the progress made by many developing countries in the 1970s), to develop indigenous sources of energy and hold down energy use. Many countries will have to accept temporary or longer-lasting restraints on demand.

(c) All countries should resolutely resist pressures, which could mount rapidly, to adopt protectionist measures. By giving the wrong signals at the wrong time, the adoption of such measures would jeopardize the entire structure of the world's open trading and currency arrangements constructed with such difficulty over the years since World War II.

(d) Governments and central banks in market centers should do whatever they can to facilitate access by LDCs to their capital and money markets. Existing regulatory or informal constraints in such areas should be relaxed.

Finance through the market

82. (a) We believe that the international banking system will have the capacity to intermediate the very large sums required, providing confidence is maintained.

(b) Although there has not yet been been a single case of a failure of, or even market concern with, a bank due to its exposure to LDCs, there are default risks in international lending; and in our judgment, these risks are increasing.

(c) Adequate standards of bank supervision are essential to the health of the system and thus to a continuing flow of capital to the developing countries. Supervision should lead to the establishment of widely-agreed prudential guidelines; it should involve exchanges of information between bank supervisors; and it should also provide for cooperative procedures to defuse a crisis. Beyond these areas of agreement, discussion revealed a range of opinion. Another study group of the Group of Thirty is examining this and other aspects of banking supervision and risk.

(d) Abrupt changes in the regulations imposed by some national authorities have occasionally had an appreciable effect on market conditions. The authorities in the leading market centers should bear in mind the consequences for the flow of funds through the markets of new regulations and approaches to supervision.

(e) When the IMF extends credit to a country in the context of an agreed adjustment program, creditor banks should preferably maintain their lending, or at least ensure that the IMF's funds provide a net addition to the total resources available to the country.

(f) Reliance cannot be placed wholly on market finance for two main reasons. First, individual countries may find themselves in intractable payments positions with an obvious need both for the adoption of adjustment policies and for finance to make the transition to a sustainable situation politically bearable. Secondly, there exists a risk that important links in the "recycling" mechanism may break down, with possibly wider consequences.

The role of the IMF

83. (a) Thus the manner in which the Fund fulfills its functions will be crucial to the stability of the system and will require the availability and use of resources on an unprecedented scale. These are necessary both to allow it effectively to encourage the adoption of constructive policies by a country in payments difficulties, and to support the solidity of the system as a whole. In our view, the Fund may well require some $20-$25 billion in borrowed funds over the next three years.

(b) The Fund's conditions for its lending must meet two tests for its success: first, that countries in need of adjustment will come to the Fund for its assistance, and secondly that the nature, the intensity, and the speed of the adjustment on which the Fund insists will be sufficient to restore, over time, the economic and financial viability of the countries that draw its resources.

(c) To encourage closer collaboration between the Fund and its members, consultations with members under Article IV could be developed further, and there might be advantages in some cases in publishing the results. A closer association between the Fund and its members would reduce the risk to which the international financing mechanism is exposed, and it would also be likely to improve the adjustment process, even if such association did not lead to a very large volume of Fund transactions.

(d) Where countries require finance, the Fund needs to stand ready to provide conditional assistance on a larger scale and over a longer period than in the past. Indeed, the Fund has already modified its practices along these lines.

(e) The Fund, like its member countries, will have to be more concerned than in the past with supply policies, not in substitution for, but in addition to, its concern with demand policies. This calls for close collaboration between the Fund and the World Bank.

(f) Another way in which the Fund contributes in a modest way to the alleviation of the debt problems of developing countries is through its annual allocations of SDRs. To the extent that these allocations meet the needs of members for increases in reserves, countries can preserve their access to credit and also acquire reserves at somewhat lower interest cost.

The role of the World Bank

84. (a) The World Bank's main contribution is to help sustain countries' development despite the adverse change in their external circum-

stances. One of the ways in which it does this is by its established programs of project and sector loans. It can also offer some assistance through its growing non-financial, advisory role. A third is through its so-called "structural adjustment" loans to help meet countries' immediate balance-of-payments difficulties. However, at a time when both the World Bank and IDA are encountering extreme difficulties in adding to their flow of resources, the bulk of balance-of-payments adjustment financing is likely to be performed by the Fund.

(b) In the field of energy, the IBRD has outlined an expanded program totalling $25 billion over a five-year period. One means being considered to mobilize finance for this program is the establishment of a new energy facility. We recognize the difficulties of establishing a separate affiliate. However, the Bank should continue to place a high priority on fostering energy resources in developing countries. Irrespective of the specific institutional mechanism that might be decided on, some way should be found to finance the program.

(c) The failure to ratify the latest replenishment of IDA resources has brought its new lending authority to a halt. Since IDA is the largest single source of concessional aid flows for the world's poorest countries, it is vital that the replenishment agreement negotiated a year ago be implemented promptly and in full. The key requirement is for the US Congress to deliver on the commitment made by the previous US Administration and reaffirmed by President Reagan's Administration.

(d) We believe that in the current exceptionally difficult circumstances the policy guideline limiting the growth of World Bank lending to 5 per cent a year in real terms should be relaxed.

(e) The study group supports the proposal that the ratio of the outstanding borrowings to capitalization should be increased (for instance, from one to two times its capital base).

The problems of the poorest

85. A new approach is needed to the payments problems of the poorest countries. In view of the bleak prospects for these countries, we believe that the international community should institute a new program under which international instututions (notably IDA and the regional development banks) would enable countries to finance agreed payments deficits at highly concessional interest rates (such as ¾ of one percent). The level for each country's deficit could be set, in advance, in the context of an agreed development plan. The additional funds required might not need

to be very large in relation to existing aid flows. Such a program would give the governments of the poorest countries better possibilities for planning their economic development and might help to defuse the ominous trend towards "confrontation" between developed and developing countries.

Other Proposals

86. The study group considered a number of other proposals for assisting the flow of capital to developing countries. However, few satisfied the criteria that the proposed scheme should offer prospects of adding significantly to the sustainable net flow of resources to the non-oil developing world, should not jeopardize their longer-term growth and should not interfere with needed adjustment.

Officers of the Group

H. Johannes Witteveen	Chairman
Robert Pringle	Executive Director
Geoffrey Bell	Executive Secretary
Robert Solomon	Treasurer

Two World Trade Center
Suite 9630
New York, New York 10048
Tel: (212) 775-9160

Group of Thirty

The Group of Thirty was established in December 1978, in order to explore the basic problems in the functioning of the international economic system. It meets twice a year, for two to three days at a time. Between these meetings, study groups and researchers gather material to serve as the basis for the Group's discussions.

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Group of Thirty

The Outlook for International Bank Lending

A survey of opinion among leading international bankers

Compiled and edited by

M.S. MENDELSOHN

for

The study group on "Capital Movements and the Growth of International Indebtedness" of the Group of Thirty

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The Outlook for International Bank Lending

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The Outlook for International Bank Lending

Preface

In recent years world economic development has become critically dependent on the lending decisions of the leading banks that play a preponderant role in the international credit markets. In the absence of a mechanism for moving funds from surplus to deficit regions, the successive sharp increases in oil prices would have plunged the world into a deep depression. In the future, even if the OPEC surplus were to diminish quite rapidly, the current account deficits of non-oil developing countries are likely to remain large. Whatever changes take place in the geographical distribution of payments imbalances, large-scale imbalances are likely to persist. Indeed, the scale of these imbalances, and thus the volume of goods and services that developing countries can import to fuel their economic development, at any given level of exports, will themselves be determined partly by the volume of international bank lending.

Thus the Group of Thirty's study group on "Capital Movements and the Growth of International Indebtedness" decided that it should commission a major inquiry to determine the views of leading international bankers on the outlook for, and constraints on, new international bank lending and the functioning of the credit markets. This report summarizes the results. It forms a companion to the report of the study group already issued under the title, "Balance-of-Payments Problems of Developing Countries". That report analyzed the nature of the challenge facing developing countries in the aftermath of the second oil "shock" and made policy recommendations on the appropriate policy response of governments, the International Monetary Fund and the World Bank, as well as the private markets. This report analyzes the views of bankers themselves.

The report is based on written answers to a questionnaire made by 52 international banks and follow-up interviews with more than 30 banks: the interviews were held usually with the bank's chief executive or the head of its

international department. The majority of the respondent banks are among the largest 100 banks in the world, including 20 of the top 50 banks, while an effort was also made to survey the views of smaller banks including regional banks with headquarters outside the main centers. The sample also included a few major investment banks and securities houses which specialize in arranging international bank loans. With regard to the geographical distribution of respondent banks, 12 were based in the United Kingdom, 11 in Japan, 7 in the United States (all these having assets of more than $14 billion), and 22 in continental Europe and other parts of the world.

The survey was compiled and edited by Mr. M.S. Mendelsohn, author of "Money on the Move: The Modern International Capital Market" published by McGraw-Hill. Interviews in the United States were conducted by Mr. Willard C. Rappleye, Editor of *Financier*, and those in Japan by the undersigned.

The members of the study group on "Capital Movements and the Growth of International Indebtedness" are

Mr. Jacques J. Polak, Executive Director, I.M.F. (Chairman);
Ambassador Roberto Campos, Brazilian Ambassador to the U.K.;
Mr. G.A. Costanzo, Vice Chairman, Citibank;
Professor Carlos F. Diaz Alejandro, Yale University;
Mr. David Holland, Chief Adviser, Bank of England;
Minister Cesar E.A. Virata, Secretary of Finance, The Philippines;
Dr. H. Johannes Witteveen, Chairman, Group of Thirty and former Managing Director, I.M.F.;
Mr. D. Joseph Wood, Director, FPA, World Bank;
Mr. Robert Pringle, Executive Director, Group of Thirty.

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Robert Pringle
August, 1981.